90-06724/

C.D. Howe Institute

Commentary

No. 21, September 1990

ISSN 0824-8001

Canada and the U.S.-Mexico Free Trade Negotiations

by

Ronald J. Wonnacott

After taking into account the possible advantages and disadvantages, it makes sense for Canada to join the upcoming free trade negotiations between the United States and Mexico.

One reason *for* seeking a three-way free trade deal is that this would avoid problems that a bilateral U.S.-Mexico agreement could create. These include: discrimination against Canadian exporters in the Mexican market, and possible nontariff discrimination and less preferred access into the U.S. market; the development — perhaps inadvertently — of the United States as the "hub of a rimless wheel," with exclusive bilateral spoke agreements with a number of countries, one at a time. Such an outcome could undermine future multilateral liberalization and seriously damage excluded countries — and eventually perhaps, Canada and other spoke countries as well. Other reasons for trilateralization are that it would strengthen the Canadian government's hand in dealing with domestic special-interest groups seeking protection, and it would provide Canada with a low-wage partner (Mexico) that would help it to compete better in a world in which other free-trade blocs have low-wage members.

The arguments *against* a three-way deal include the short-run adjustment costs that could be created by a free entry of low-wage Mexican goods and the political contention the issue would raise. No doubt, adjustment to free trade with Mexico (as with the Canada-U.S. Agreement) may not be easy. Still, on balance, all three countries stand to benefit from the greater strengthening of the Mexican economy, and the increased ability of each, under a more competitive and productive trading regime, to service debt.

Thus, it is important for Canada to be at the table, either to play a formal role in bringing Mexico into the Canada-U.S. Agreement, or to monitor any U.S.-Mexico bilateral agreement to ensure that its provisions are as close as possible to those in the Canada-U.S. deal.

Introduction

As the United States and Mexico prepare to negotiate a free trade agreement, Canada must address the question: To what degree should it participate? The reaction of many Canadians already heavily involved in adjusting to the Canada-U.S. Free Trade Agreement in the face of high interest rates and a high Canadian dollar will be: "Extending free trade to Mexico may be a promising idea in the future, but not just yet." However, Canadians have no control over the timing, as they did in the Canada-U.S. Agreement. Canada's decision on whether to participate in U.S.-Mexico free trade talks cannot be put off, since those two countries have now decided to proceed at an accelerated pace.

This paper addresses some of the issues that arise in any Canadian decision to participate. Since there are arguments both for and against, it is perhaps no surprise that the signals coming out of Ottawa have been mixed. Specifically, the questions to begin with are: Should Canada participate with the objective of expanding the existing Agreement to include Mexico? Or should Canada allow the United States and Mexico to go ahead and create a bilateral agreement on their own?

Reasons for Including Mexico in the Canada-U.S. Free Trade Agreement

To Avoid Discrimination against Canadian Exporters in the Mexican Market

In a full three-country free trade area, Canada would avoid a problem that would be created by a bilateral U.S.-Mexico agreement — namely, the problem of Canadian exporters being discriminated against in the Mexican market in competition with the United States.[1] The limited amount of Canada-Mexico trade suggests that this may not be an important issue, at least at first, although it could become more significant in the future if this discrimination were to deter substantial Canadian exports to Mexico that would have otherwise developed. For example, in bilateral U.S.-Mexico negotiations, the United States might be able to negotiate relief from Mexican restrictions on U.S. auto exports that would leave Canadian auto exporters at a competitive disadvantage in the Mexican market. This disadvantage would be avoided in a three-country negotiation, which would provide Canadian exports with the same relief.

A bilateral U.S.-Mexico agreement would not, however, leave Canadian exporters with the other traditional problem of outsiders — that is, the problem of facing tariff discrimination in the U.S. market in competition with Mexico — since Canada already has tariff-free access to the U.S. market under the Canada-U.S. Free Trade Agreement. Instead, Canada would only lose an advantage that has just been created by the Agreement — namely, the preference Canada now gets in the U.S. market in competition with Mexico. But Canada's loss of preference will occur as a result of any U.S.-Mexico free trade agreement, whether or not Canada participates. This is an important point to keep in mind in evaluating recent Canadian hopes of defending the gains Canada has acquired under the Canada-U.S. Agreement. One of those gains — preference in the U.S. market in competition with Mexico — cannot be defended; it will disappear with any U.S.-Mexico agreement, whether or not Canada participates. Another way of putting this point is to recognize that, participate or not, Canada will have to compete with Mexico over a large domain of its sales — namely, in the U.S. market.

To Avoid Facing Nontariff Discrimination in the U.S. Market

While a bilateral U.S.-Mexico agreement would not leave Canada facing tariff discrimination in the U.S. market, it might leave Canada facing nontariff discrimination. This would occur if Mexico were able to negotiate, bilaterally, more secure access to the United States than Canada now gets. Thus, one of the spe-

cific reasons for wishing to "trilateralize" the negotiations would be to ensure that Canada receives at least as favorable treatment in the U.S. market as does Mexico. In the Canada-U.S. negotiations, Canadian negotiators seemed to foresee this problem; they reportedly tried to ensure that Canada would automatically receive any benefits that the United States might extend to any other country, such as Mexico. However, the United States was not prepared to accept this constraint.

To Enable Canada to Participate in Negotiations on Special Clauses for Particular Sectors

It is important for Canada to participate in the negotiation of other special clauses, such as any temporary safeguard provisions that might conceivably be negotiated for, say, the Mexican auto industry. Canada already has auto safeguards, but these will disappear if and when world auto tariffs are multilaterally eliminated in the General Agreement on Tariffs and Trade (GATT). In the unlikely event that the United States were to allow the Mexican industry temporary production safeguards, would these disappear at least as rapidly as the Canadian safeguards? If not, the Canadian industry might find itself at a future disadvantage in competing with Mexico.

To Increase Canada's Weight in Settling Trade Disputes

Should Canada seek to participate in the negotiations in order to trilateralize dispute settlement between the three countries? A trilateral resolution of disputes would provide Canada and Mexico together with greater weight in holding the United States to its commitments than either would have alone. But for precisely this reason, it is far from clear that the United States would accept the trilateralizing of dispute settlement. The United States' concern with being outvoted in a three-country body might be described by a U.S. version of a classical Mexican complaint: "The poor United States — so far from God, and squeezed between Canada and Mexico."[2] Nor is it even clear that Canada would wish to trilateralize dispute settlement, since this could weaken, rather than strengthen, Canada's voice in disputes with the United States where Mexico did not support Canada's position. In this area, as in some of the others cited here, the Canadian interest is not simple and clear cut.

To Strengthen Canada's Hand in Dealing with Protectionist Demands by Special-Interest Groups

Free trade with Mexico (as well as with the United States) should strengthen the Canadian government's hand in dealing with domestic special-interest groups seeking protection. This could be very important, for example, in negotiating better Mexican access to the Canadian market in low-wage, labor-intensive products. In the absence of such a trade negotiation, the Canadian government might find it politically difficult to relax protection on such goods.

To Ensure the United States Does Not Become the "Hub of a Rimless Wheel"

Canada should seek to trilateralize any U.S. agreement with Mexico, or with any other country, as part of a broader strategy to ensure that the United States does not — perhaps inadvertently — become the "hub of a rimless wheel" by establishing exclusive bilateral spoke agreements with a number of countries, one at a time. While any such specific bilateral agreement might well benefit both the United States and the spoke country involved, it would damage excluded countries. Moreover, as these bilateral agreements with the United States accumulate, even spoke countries may eventually be damaged. Most important, once a critical mass of these agreements is reached, it could weaken the United States' incentive to initiate and support further rounds of multilateral liberalization and could damage all credibility in the multilateral trading system. Thus, it could become the ultimate abuse of

the Article XXIV exemption to the GATT's most-favored-nation principle. From the point of view of world welfare, preventing this development is arguably the most important reason for Canada to trilateralize the negotiations.[3]

To Have a Low-Wage Partner in the Free Trade Bloc

Finally, Canada, like the United States, needs a low-wage partner such as Mexico. Every other participating country in a free-trade bloc has such a partner. Without access to a pool of low-wage labor, Canadian industry will find it more difficult to remain competitive in world markets. However, low wages in Mexico will raise the question: How can Canadian industry compete with cheap Mexican labor?

Problems for Canada Arising from a Three-Country Free Trade Area

Before addressing the problems that might arise from Canada's participation in a full three-country free trade area, it is important to re-emphasize that Canada will be exposed to a number of risks whether or not it joins the United States and Mexico in negotiations. For example, as already noted, Canada would lose its preference in the U.S. market if the United States and Mexico were to negotiate a free trade agreement, whether or not Canada were to participate. To address the question: Should Canada participate?, it is important to address those issues on which Canadian participation would make a difference.

The Duty-Free Entry of Low-Wage Mexican Products

First, if Canada were to participate in the creation of a three-country free trade area, low-wage Mexican products would enter Canada duty free. There is a risk that the whole debate in Canada prior to the free trade election in 1988 might be reopened.

At that time, it was charged that Canadian industry could not compete with low-wage Maquiladora products that, in the proposed Canada-U.S. Agreement, would get unrestricted entry into Canada through the United States. It was pointed out that this was not so. True, Mexican products — just like products from other developing countries — receive preferential access to the U.S. market under the GSP (Generalized System of Preferences). Moreover, under U.S. tariff items 806.30 and 807, Mexican products with U.S. content enter the United States with no duty on that U.S. content, just like 806-807 products from other countries. But such products would not automatically be able to move from the United States to Canada duty free, since they would be subject to the Agreement's rule of (Canadian or U.S.) origin. While this concern was therefore not an issue in the Canadian debate prior to the Agreement, it would become an issue in any three-country agreement because the rule of origin would then be defined to include Mexican — as well as U.S. and Canadian — content. Mexican products satisfying the rule of origin would come into Canada duty free. Thus, the question of competition in Canada with low-wage Mexican industry would have to be dealt with directly.

What might a rerun of the 1988 free trade debate in Canada be like? Those who then opposed free trade with the United States for protectionist reasons might argue that the Agreement was a mistake because it was the first step in a two-stage process that is leading Canadians into direct competition with low-wage Mexican labor. But this argument would be based on the assumption that Canada could have somehow preserved the status quo in a rapidly changing world. Thus, the Agreement's supporters could argue that no matter what Canada did, it could not have preserved the status quo. Specifically, Canada could not have prevented the United States and Mexico from now liberalizing their trade; and without the Canada-U.S. Agreement, Canada would now be an outsider, excluded from an emerging free trade area between the United States and Mexico, and hence facing discrimination in the U.S. market. In other words, without the Agreement, Canada would

not only have failed to achieve the better access to the U.S. market that it has provided; worse yet, Canadians would now also face even greater problems in selling in the United States because they would be discriminated against there in competition with Mexicans. Furthermore, any attempt by Canadians now to deal with this problem by seeking free entry into the U.S. market would require much more difficult negotiations with the United States and Mexico. The Canada-U.S. negotiations were difficult enough. In actual practice, negotiating the entry of Canada into a U.S.-Mexico agreement would involve accepting many of the conditions in that agreement; Canadians could not expect to get an agreement as sensitive to their concerns as was achieved in the Canada-U.S. negotiations.

Nonetheless, Canadian concerns remain about increased competition from low-wage Mexican firms. The traditional reply is that the greater the differences between countries in factor endowments and factor prices such as wages, the greater the comparative-advantage gains from trade liberalization. If costs are dead equal, then there is no comparative advantage and no gains from trade as a consequence — although there may be other gains from trade arising from economies of scale, etc.

Another answer is to recognize that Mexico also has fears about competing with Canada and the United States: Canadians fear Mexicans' low wages, while Mexicans fear Canadians' high productivity. Both can acquire long-term gains from free trade — Mexicans by specializing in labor-intensive products in which their low wage rate gives them a comparative advantage, and Canadians and Americans by specializing in products where their higher productivity gives them a comparative advantage — that is, products with heavy requirements of human capital and the industrial infrastructure that Mexico lacks.[4] The problem is that short-run adjustment in the United States and Canada would be a politically sensitive issue because it could involve the substantial displacement and reemployment of low-wage workers.

C.D. Howe Institute Commentary © is a periodic analysis of, and commentary on, current public policy issues.

Ronald J. Wonnacott, the author of this issue, is Professor of Economics at the University of Western Ontario. This paper is an updated version of a paper presented to the International Forum: Mexico's Trade Options in the Changing International Economy, held by the Universidad Tecnologica de Mexico, in Mexico City on June 11–15, 1990.

As with all Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

For further information, please contact: Barry A. Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866).

This publication can be obtained, at $5.00 per copy, from: Renouf Publishing Company Limited, 1294 Algoma Road, Ottawa, Ontario K1B 3W8 (tel.: 613-741-4333; fax: 613-741-5439), or from Renouf's stores at 61 Sparks Street Ottawa, Ontario (tel.: 613-238-8985) and 211 Yonge Street, Toronto, Ontario (tel.: 416-363-3171).

Quotation with appropriate credit is permissible.

ISBN 0-88806-265-6

Investment in plant and equipment by U.S. and Canadian firms in Mexico may raise Mexican productivity — perhaps rapidly — but the increase in Mexican human capital with improvements in education will take much longer. As Mexican productivity increases over time and Mexican wages accordingly rise, Mexicans will fear competition with Canadians less because the productivity gap will be closing, and we will fear competition with them less because the wage gap will be closing.

Rising Mexican wages would offer a number of benefits in addition to the obvious benefit of a higher income for the Mexican labor force. Producers in all three countries would benefit from increased sales to higher-income Mexicans. And reduction of the income gap between Mexico and the United States would reduce the problem of illegal migration at the source (by reducing the incentive) — a solution that is far superior to the current U.S. attempt

to contain this migration by legal action. (This is a difficult issue, and ultimately may put the negotiations with Mexico at risk.)

To sum up: to economists, low Mexican wages provide an opportunity for Canadian consumers to acquire lower-priced goods and for Canadian producers to become more internationally competitive by acquiring lower-cost inputs. However, for politicians and for Canadian producers in direct competition with Mexican firms, low Mexican wages raise a problem, which may be exacerbated by:

- the recent emergence in Mexico of industries that Canadians value highly, such as electrical equipment, telecommunications, and autos;
- a higher rate of inflation in Mexico than in Canada and the United States, and thus a continuous depreciation or devaluation of the peso. Even though the pressure from Mexican competition on Canadian producers may be only the normal pressure of adjusting to trade liberalization, Canadian producers may wrongly interpret their problem as being unable to compete because of an "unfair" depreciation of the peso;
- a large, shrinkage-resistant fiscal deficit in Canada that has left monetary policy with the responsibility for controlling inflation, with the high interest rates and value of the Canadian dollar that this implies. This has made it very difficult for trade-sensitive Canadian industries to compete.

Possible Dilution of the Canada-U.S. Agreement

Second, Canada is concerned that any negotiation of a trilateral agreement could dilute the carefully crafted set of two-way concessions now bound into the Canada-U.S. Agreement. As a hypothetical example, the United States might resist pressure by Mexico for safeguards in auto production by pressing Canada to water down its existing auto safeguards.

Possible Diversion of Attention from Canada-U.S. Subsidies Negotiations

Third, trilateral negotiations could divert attention away from negotiations on dumping and subsidies required by the Canada-U.S. Agreement. While a trilateral agreement on these thorny issues might be even more advantageous, the attempt to get such an agreement could mean that negotiations that might otherwise succeed on a bilateral basis might bog down in a trilateral forum.

Final Observations

These considerations lead to the conclusion that, on balance, Canada does have a strong interest in trilateralizing any U.S.-Mexico negotiations. Moreover, to the reasons cited above must be added the benefit to all three countries from the strengthening of the Mexican economy. Furthermore, a liberalized and expanded trade would, by raising real income, increase the ability to service debt of all three countries — especially Mexico.

The most straightforward method of trilateralizing the negotiations would be to have the Canada-U.S. Agreement extended to include Mexico. However, this would not be a simple task. For example, in one industry alone — autos — difficult issues would arise: Would Mexico be granted the present status of the United States or the quite different status of Canada — or some status between the two? More broadly, what parts of the present Canada-U.S. Agreement would Mexico find unacceptable? What issues would the United States and Mexico wish to cover that are not included in the Canada-U.S. Agreement.

The result of such a tripartite negotiation would be a Canada-Mexico-U.S. free trade agreement embracing those central "core" provisions of the Canada-U.S. pact on which the three countries could agree, overlaid by a "hub-and-spoke" set of agreements on which they could not agree — and on which Canada and Mexico would each have its own separate "bilateral" with the United States.[5] To mini-

mize the risk that the United States would develop by default as the center of a hub-and-spoke system, it would be essential that the core provisions of a tripartite agreement be maximized, and that the hub-and-spoke provisions on which only two countries agree be minimized. One method of doing this would be to make temporary as many Mexican hub-and-spoke provisions as possible, and then phase them out over time, or phase them into the core — that is, into conformity with the Canada-U.S. Agreement. As this took place, the tripartite accord would increasingly have its desirable core characteristics dominate its undesirable hub-and-spoke characteristics.

Such an ambitious tripartite negotiation may now not be feasible — or, given the timing, even desirable from Canada's point of view. Accordingly, suppose instead that the United States proceeds to negotiate a bilateral agreement with Mexico. Should Canada play a role? In my judgement, *it is essential for Canada to be at the table*, for two broad reasons. The first is to ensure that Canada's interests are protected. One example illustrates the multitude of such issues that will arise: dealing appropriately with the Maquiladoras — as the duty drawback issue was dealt with in the Canada-U.S. Agreement — to ensure that Canada (and the United States as well) will not face a costly trade distortion that will induce into Mexico a substantial amount of third-country investment that would otherwise locate in Canada or the United States. The other essential reason for Canada to be at the table is to ensure that as many of the provisions in the U.S.-Mexico bilateral deal as possible are the same as the provisions in the Canada-U.S. Agreement. The result will still be a hub-and-spoke arrangement, but this discipline will simplify the task in the future of folding the two U.S.-centered accords into a tripartite free trade area with minimal hub-and-spoke overlay.

It is important to re-emphasize that, in either case, it is essential for Canada to be at the table playing a monitoring role that both the United States and Mexico should welcome. It is just as important for Mexico as for Canada to ensure that the United States does not, perhaps inadvertently, develop as the center of a hub-and-spoke regime. It is equally important for the United States. Because of its central location and economic size, the United States will dominate even a completely symmetric free trade area. It is not in its foreign policy interest to be seen as further dominating North American economic activity by developing a hub-and-spoke trading regime that, compared to a tripartite free trade area, benefits itself at the expense of Canada and Mexico.

Notes

1. One possible reason that Canada should try to expand its Free Trade Agreement with the United States to include Mexico is that this would reduce Canadian trade diversion under the Agreement, since some import purchases from Mexico would no longer be diverted to higher-cost U.S. sources. In another respect, however, this expansion of the Agreement would make trade diversion more costly for Canada, since some import purchases would then be diverted from other countries to Mexico. It is difficult to assess how these two would trade off.

   In the literature on North American free trade, the term "diversion" is often used too broadly. To see why, suppose that, as a result of the Canada-U.S. Agreement, Canada diverts its trade by purchasing imports from the United States rather than from a lower-cost source such as Mexico. Then it is Canada that has diverted trade, and there is a cost to Canada because it is purchasing higher-cost imports. But this Canadian trade diversion has a favorable effect on the United States because of its having acquired preference in the Canadian market. This Canadian trade diversion has also had an unfavorable effect on Mexico, which now loses sales because it faces discrimination in the Canadian market in competition with the United States. In the literature, any or all of these three effects are sometimes called diversion. In the specific example cited, authors may refer correctly to the "cost of trade diversion in Canada" or erroneously to the "cost of trade diversion in Mexico." This confusion can be avoided by more specifically referring in this example to Canadian trade diversion, the United States' preference in the Canadian market, and the discrimination Mexico faces in the Canadian market.

2. This recasting of the Mexican complaint "Poor Mexico: So far from God and so close to the United States" developed in a conversation with Michael Hart and

Peter Morici, whose views on a number of the problems addressed in this paper have been very valuable.

3. It has traditionally been recognized that an n-country free trade area may possibly have a damaging effect on world welfare. For details on why an n-country rimless wheel would be more damaging, see Ronald J. Wonnacott, *Would U.S. Hub-and-spoke Bilaterals Put the Multilateral Trading System at Risk?*, C.D. Howe Institute Commentary (Toronto: C.D. Howe Institute, forthcoming). Was the Canada-U.S. Agreement the first step in the abuse of Article XXIV of the GATT? If it were the first step in the creation of a three-country (and perhaps later, an n-country) free trade area, the answer would be: No more than the development and expansion of the European Community. In fact, less, since the Canada-U.S. Agreement did not substantially increase protection against excluded countries. But if the Agreement were the first step in the creation of a U.S.-centered rimless wheel, then the answer would be: Yes, it was the first step in this ultimate abuse of Article XXIV. This is the reason why Canada should seek not only to trilateralize any agreement between the United States and Mexico, but also to ensure the "trilateralizing" of any future negotiations between the United States and any other country. (Although the Canada-U.S. Agreement is viewed here as the first free trade agreement signed by the United States, it did, in fact, follow one with Israel. However, in economic terms, the U.S.-Israel arrangement was not significant enough to raise the issues addressed here.)

4. This traditional pattern of specialization will doubtless vary, depending on special conditions. For example, because of strong efficiencies in the auto industry from lean production with just-in-time inventory management and so on, there is a tendency toward Toyota-style production of all components — regardless of their labor intensity — in the location of final assembly of a model. Although labor intensity and low labor costs are not governing considerations here, they may be in determining where each model is produced. For example, James Womack of the Massachusetts Institute of Technology predicts that inexpensive, entry-level models will be produced in Mexico — attracted there by the savings in labor costs that are important for price-sensitive buyers — while upmarket models will be produced in Canada and the United States. (He also predicts that many of the inexpensive models that are produced in Mexico will gravitate there, not so much from Canada and the United States as from their present locations in Southeast Asia. This would limit the job losses of auto workers in Canada and the United States, and could even make it possible for the Big Three auto firms to make "no job loss" guarantees.

5. The Canadian "bilateral" with the United States would be those provisions in the Canada-U.S. Agreement to which Mexico could not agree. Thus, an objective of the negotiations would be to leave the existing Canada-U.S. deal as it stands.

Bibliography

Bilateral Commission on the Future of U.S.-Mexican Relations. *The Challenge of Interdependence*. New York: Lanham, 1989.

Bucay, Nisso, and Eduardo Perez Motto. "Trade Negotiation Strategy for Mexico." In John Whalley, ed., *Developing Countries and the Global Trading System*, vol. 2. London: Macmillan, 1989.

Hart, Michael. "A North American Free Trade Agreement: The Elements Involved." Paper presented to the International Forum: Mexico's Trade Options in the Changing International Economy, held by the Universidad Tecnologica de Mexico, Mexico City, June 11-15, 1990.

Lipsey, Richard G., and Robert C. York. *Evaluating the Free Trade Deal: A Guided Tour through the Canada-U.S. Agreement*. Toronto: C.D. Howe Institute, 1988.

Morici, Peter, "Why Canada Must Sit at U.S.-Mexico Table," Report on Free Trade, *Globe and Mail* (Toronto), May 7, 1990.

Smith, Murray G., and Frank Stone. *Assessing the Canada-U.S. Free Trade Agreement*. Ottawa: Institute for Research on Public Policy, 1987.

Trigueros, Ignacio. "A Free Trade Agreement between Mexico and the United States?" In Jeffrey J. Schott, ed., *Free Trade Areas and U.S. Trade Policy*. Washington: Institute for International Economics, 1989.

Weintraub, Sidney. *A Marriage of Convenience: Relations between Mexico and the United States*. New York: Oxford University Press, 1990.

Womack, James. "North American Integration in the Motor Vehicle Sector: Logic and Consequences." Paper presented to the International Forum: Mexico's Trade Options in the Changing International Economy, held by the Universidad Tecnologica de Mexico, Mexico City, June 11-15, 1990.

Wonnacott, Ronald J. *Would U.S. Hub-and-Spoke Bilaterals Put the Multilateral Trading System at Risk?*, C.D. Howe Institute Commentary. Toronto: C.D. Howe Institute, forthcoming.